

PIPEs

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The proliferation of Private Investments in Public Equity (“PIPEs”) and the success enjoyed by hedge funds in investing in them has caught the attention of the U.S. Securities and Exchange Commission (“SEC”). Over the last two years, the SEC has brought a number of enforcement actions against hedge funds accusing them of insider trading and violations of the registration requirement of the Securities Act of 1933 (“Securities Act”) in connection with PIPE investments. Additionally, the SEC has recently reinterpreted the dividing line between a primary and secondary resale offering in an effort to rein in the PIPE market. This article discusses and analyzes these developments.

I. INTRODUCTION

Private Investments in Public Equity (“PIPEs”) have become an important source of financing for many public companies. In 2006, companies closed on 1,329 PIPE deals raising approximately \$28.2 billion in the aggregate.¹ These numbers easily surpass the previous records of 1,106 deals and \$23.3 billion set in 2000 (the height of the dot-com bubble).² While companies of all sizes have used PIPEs to raise money,

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¹ See Sagient Research Systems, Inc., PlacementTracker, Private Placement Resources, <http://www.sagientresearch.com/pt/GStats.cfm?Type=6> (last visited Aug. 30, 2007).

² The following table sets forth the annual number of PIPE deals and aggregate dollar amounts raised from 1995 to 2006. See *id.* The data excludes PIPE deals by Canadian companies.

| Year | Deals | Amount |
|------|-------|------------------|
| 2006 | 1,343 | \$28,308,956,049 |
| 2005 | 1,304 | \$20,010,059,164 |
| 2004 | 1,270 | \$15,641,845,069 |
| 2003 | 882 | \$12,632,749,396 |
| 2002 | 707 | \$12,264,034,876 |
| 2001 | 898 | \$14,604,527,934 |
| 2000 | 1,106 | \$24,337,925,804 |
| 1999 | 676 | \$10,258,789,616 |
| 1998 | 428 | \$2,998,805,923 |
| 1997 | 448 | \$4,747,221,485 |
| 1996 | 306 | \$4,101,292,110 |

PIPE deals have emerged as a vital financing source for small public companies. In fact, approximately 90 percent of all PIPE deals in 2006 were completed by companies with market capitalizations of \$250 million or less.³ This is driven by the reality that PIPEs represent the only available financing option for many small public companies.⁴

Hedge funds provide a large percentage of small company PIPE financing.⁵ They do so because it pays off; PIPE investments have earned hedge funds market-beating returns.⁶ These favorable returns have not, however, resulted from improved post-financing performance by PIPE issuers. As a group, PIPE issuers have performed poorly before and after PIPE financings.⁷ Hedge funds are nonetheless able to beat the market because of advantageous deal terms they secure from PIPE issuers.⁸

The proliferation of PIPEs and the success enjoyed by hedge funds in investing in them have caught the attention of the U.S. Securities and Exchange Commission ("SEC"). Over the last two years, the SEC has brought a number of enforcement actions against hedge funds accusing them of insider trading and violations of the registration requirement of the Securities Act of 1933 ("Securities Act")⁹ in connection with PIPE investments. Additionally, the SEC has recently reinterpreted the dividing line between a primary and secondary resale offering in an effort to rein in the PIPE market.

This article discusses and analyzes these developments. Part II describes common characteristics of PIPE deals, including the types of securities issued and the basic trading strategy employed by hedge funds. Part III details securities law compliance issues with respect to PIPE transactions. Part IV explores recent SEC enforcement actions. In particular, it critiques the SEC's stance that covering a short sale with PIPE

| | | |
|-------|--------|-------------------|
| 1995 | 114 | \$1,334,025,502 |
| Total | 10,372 | \$186,335,356,738 |

³ Gregory Sichenzia, Panel Discussion at the Entrepreneurial Business Law Journal Symposium: IPOs in the Internet Age: The Case for Updated Regulations (Mar. 2, 2007). "Nano-cap" companies (companies with market capitalizations below \$50 million) completed 53% of the deals, and "micro cap" companies (companies with market capitalizations from \$50 to \$250 million) completed 27% of the deals. *See id.*

⁴ *See* Susan J. Chaplinsky and David Haushalter, *Financing Under Extreme Uncertainty: Contract Terms and Returns to Private Investments in Public Equity* (May 2006), available at <http://ssrn.com/abstract=907676>.

⁵ *See id.*; David J. Brophy et al., *Hedge Funds as Investors as Last Resort?*, REV. OF FIN. STUD., forthcoming. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=782791.

⁶ *See* Chaplinsky & Haushalter, *supra* note 4, at 4; Brophy, *supra* note 5, at 4.

⁷ *See* Chaplinsky & Haushalter, *supra* note 4, at 3.

⁸ *See id.* at 14; Brophy, *supra* note 5, at 4.

⁹ 15 U.S.C. § 77 (2006). *See infra* Part IV (discussing recent SEC enforcement actions).

shares violates Section 5 of the Securities Act. Part V argues that by investing in a PIPE and promptly selling short the issuer's common stock, a hedge fund is essentially underwriting a follow-on public offerings while legally avoiding many of the regulations applicable to underwriters. This "regulatory arbitrage" makes it possible for hedge funds to secure the advantageous terms responsible for the market-beating returns they have garnered from PIPE investments. Part V then discusses the SEC's response and the effect the response has on PIPE issuers. Considering the importance of PIPE financing to small public companies, Part VI concludes that a more measured and transparent SEC approach to PIPE regulation is in order.

II. PIPE CHARACTERISTICS

A PIPE is a type of financing transaction undertaken by a public company, normally with a small number of sophisticated investors. In a typical PIPE, the company relies on an exemption from SEC registration requirements to issue investors common stock or securities convertible into common stock for cash.¹⁰ The company then registers the resale of the common stock issued in the private placement, or issued upon conversion of the convertible securities issued in the private placement, with the SEC.¹¹ Generally, investors must hold securities issued in a private placement for at least one year.¹² However, because the company registers the resale of the PIPE shares, investors are free to sell them into the market as soon as the SEC declares the resale registration statement effective (typically within a few months of the closing of the private placement).¹³

A. Types of PIPEs

PIPE transactions are highly negotiated; hence there is a fair amount of variation from deal to deal with respect to the attributes of the PIPE securities.¹⁴ PIPE securities may consist of common stock or securities convertible into common stock, such as convertible preferred

¹⁰ James R. Tanenbaum & Anna T. Pinedo, *The Law: Legal and Regulatory Framework*, in PIPES: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY 77, 93 (rev. & updated ed. 2006).

¹¹ *Id.* at 99.

¹² See *infra* text accompanying notes 79 & 80.

¹³ See Chaplinsky & Haushalter, *supra* note 4, at 1.

¹⁴ See Brophy, *supra* note 5 ("[T]he negotiations between the issuing companies and their investors in private issuances result in highly customized securities."); Richard E. Gormley, OVERVIEW: AN EMERGING MARKET, in PIPES: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY 9, 13 (rev. & updated ed. 2006) ("Although the PIPE market is becoming more standardized each year [. . .], it remains a highly negotiated marketplace.").

stock or convertible notes, and may be coupled with common stock warrants.¹⁵ Regardless of the type of securities involved, PIPE deals are categorized as either traditional or structured.¹⁶ With a traditional PIPE, the PIPE shares are issued at a price fixed on the closing date of the private placement.¹⁷ This fixed price is typically set at a discount to the trailing average of the market price of the issuer's common stock for some period of days prior to closing of the private placement.¹⁸ As mentioned above, securities regulations generally prohibit investors from selling PIPE shares prior to the SEC declaring the resale registration statement effective.¹⁹ Thus, because the deal price is fixed, investors in traditional PIPEs assume price risk, which is the risk of future declines in the market price of the issuer's common stock during the pendency of the resale registration statement. Of the 1,343 PIPE deals closed in 2006, 1,111 (82.7%) involved traditional PIPEs.²⁰

With a structured PIPE, the issuance price of the PIPE shares is not fixed on the closing date of the private placement. Instead it adjusts (often, downward only)²¹ based on future price movements of the issuer's common stock.²² For example, investors may be issued convertible debt or preferred stock that is convertible into common stock based on a floating or variable conversion price, i.e., the conversion price fluctuates with the market price of the issuer's common stock.²³ Hence, with a structured PIPE, investors

¹⁵ Gormley, *supra* note 14, at 13.

¹⁶ See Brophy, *supra* note 5, at 2.

¹⁷ See *id.*

¹⁸ See Gormley, *supra* note 14, at 22. The trailing average is customarily based on either the closing bid prices or volume weighted average prices for the issuer's common stock from one to twenty days prior to closing.

¹⁹ See *supra* text accompanying notes 12 & 13.

²⁰ See Sagient Research Systems, Inc., PlacementTracker – Private Placement Resources, <http://www.sagientresearch.com/pt/GStats.cfm?Type=4> (last visited Sept. 7, 2007). The data excludes PIPE deals by Canadian companies.

²¹ See Chaplinsky & Haushalter, *supra* note 4, at 13 (In a recent study of structured PIPEs, Chaplinsky & Haushalter found about half cap upward adjustments at market price on the private placement closing date. They did note that some PIPE securities do allow the conversion price to adjust upward above the price on the issuance date but no PIPE securities included in the sample provided for unlimited upside adjustment. *Id.* at 14.).

²² See Brophy, *supra* note 5, at 7. See also E. Kurt Kim, *The Marketplace: A STATISTICAL SUMMARY, IN PIPES: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY* 27, 43 (rev. & updated ed. 2006).

²³ See *id.* See also Chaplinsky & Haushalter, *supra* note 4, at 13. A variation on the theme is a conversion price reset feature. With such a feature, the conversion price is initially fixed but adjusts or resets on a particular day or days in the future based on the then existing market price of the issuer's common stock. For example, a convertible note with a reset price feature may initially fix the conversion price at 90% of the market price on the closing date but provide for adjustment six months and one year from the closing date to 90% of the market price of the issuer's common stock on the adjustment date. *Id.* See also Kim, *supra* note 22, at 42.

do not assume price risk during the pendency of the resale registration statement.²⁴ If the market price declines, so too does the conversion price, and therefore the PIPE securities will be convertible into a greater number of shares of common stock.

For example, say an investor purchases a \$1,000,000 convertible note in a PIPE transaction, and the note provides that the principal amount is convertible at the holder's option into the issuer's common stock at a conversion rate of 90-percent of the per share market price of the stock on the date of conversion. Thus, if the market price of the issuer's common stock is \$10 per share, the note is convertible at \$9.00 a share into 111,111 shares of common stock. If the market price drops to \$8 per share, the note is then convertible at \$7.20 per share into 138,889 shares of common stock. Regardless of how low the price drops, upon conversion the investor will receive \$1,000,000 of common stock based on the discounted market price of the stock on the day of conversion.

Some structured PIPEs do contain floors on how low the conversion price can adjust downward or caps on how many shares can be issued upon conversion.²⁵ If a structured PIPE has neither a floor nor cap, it can potentially become convertible into a controlling stake of the PIPE issuer. Continuing the example from above, if the market price dropped to \$0.01, the note would then be convertible into more than 100 million shares,²⁶ which would constitute a controlling stake unless the issuer had at least 200 million shares outstanding. Hence, structured PIPEs lacking floors or caps are pejoratively labeled "death spirals" or "toxic converts" because investors in these deals may be tempted to push down the issuer's stock price through short sales, circulating false negative rumors, etc., so that their structured PIPEs become convertible into a controlling stake of the issuer.²⁷ Of the 1,343 PIPE deals closed in 2006, 317 (23.6%) involved structured PIPEs.²⁸

B. Registration Requirement

The registration requirement of a PIPE transaction can be either concurrent or trailing. With a concurrent registration requirement, investors commit to buy a specified dollar amount of PIPE securities in the private placement, but their obligations to fund are conditional on the SEC

²⁴ See Brophy, *supra* note 5, at 7.

²⁵ See Chaplinsky & Haushalter, *supra* note 4, at 13.

²⁶ The calculation would be $\$1,000,000/(\$0.01 \times 0.9) = 111,111,111$.

²⁷ See Leib M. Lerner, *Disclosing Toxic PIPEs: Why the SEC Can and Should Expand Reporting Requirements Surrounding Private Investments in Public Equities*, 58 BUS. LAW. 655, 658 (2003).

²⁸ See Sagient Research Systems, Inc., PlacementTracker – Private Placement Resources, <http://www.sagientresearch.com/pt/GStats.cfm?Type=5> (last visited Sept. 7, 2007).

indicating that it is prepared to declare the resale registration statement effective.²⁹ If the SEC never gets to this point, the investors do not have to go forward with the deal. Thus, the issuer bears the registration risk; that is, the risk that the SEC will refuse to declare the resale registration statement effective.

With a trailing registration rights requirement, the parties close on the private placement and then the issuer files a registration statement.³⁰ Consequently, the investors bear the registration risk. If the issuer never files or the SEC never declares the registration statement effective, the investors will not be able to sell their PIPE shares into the market for at least one year.³¹ As a result, PIPE deals that include such trailing registration requirements typically obligate the issuer to file the registration statement within thirty days of the private placement closing date and require that it be declared effective within 90 to 120 days of such date.³² If these deadlines are not met, the issuer is obligated to pay the investors a penalty of 1-percent to 2-percent of the deal proceeds per month until filing or effectiveness.³³

C. PIPE Issuers

As mentioned above, the large majority of PIPE deals are undertaken by small public companies. These companies generally pursue PIPEs not because they offer advantages over other financing alternatives but because the companies have no other financing alternatives.³⁴ By and large, PIPE issuers are not only small in terms of market capitalization but have weak cash flow and poorly performing stocks. A recent study of PIPE issuers by Professors Chaplinsky and Haushalter found that “more than 84% of PIPE issuers have negative operating cash flow and over 50% of the issuers have falling stock prices in the year prior to issue.”³⁵ Further, a majority of them will run out of cash within a year unless they obtain additional financing.³⁶ Thus, traditional forms of financing are simply not

²⁹ See Tanenbaum & Pinedo, *supra* note 10, at 100.

³⁰ See *id.* at 105.

³¹ See *infra* note 58 & 59.

³² See Snell & Wilmer L.L.P., *Raising Capital Through a PIPE Transaction*, 2006, at 2, available at http://www.sec.gov/info/smallbus/gbfor25_2006/pidgeon_lewis_pipes.pdf.

³³ See *id.*

³⁴ The primary purported advantages of financing through a PIPE is speed. *Id.* It is not uncommon for a PIPE deal to close within seven to ten days of receiving definitive purchase commitments whereas a follow-on underwritten equity offering can take from three to nine months. Tanenbaum & Pinedo, *supra* note 10, at 100. This quick timeframe is possible because a PIPE can be structured so that no pre-closing SEC review and clearance is required, and PIPE investors generally perform much less due diligence on the PIPE issuer than an underwriter would.

³⁵ Chaplinsky & Haushalter, *supra* note 4, at 2.

³⁶ *Id.*

an option.³⁷ Few, if any, investment banking firms are willing to underwrite follow-on offerings for small, distressed public companies.³⁸ Further, these companies lack the collateral and financial performance to qualify for bank loans and the upside potential to attract traditional private equity financing.³⁹

Given the distressed status of PIPE issuers, PIPE financing can, of course, be very expensive. Not only does the company typically issue common stock or common stock equivalents at a discount to market price, but PIPE deals often involve other cash flow rights such as dividends or interest (typically paid in kind not cash) and warrants.⁴⁰ After taking into account these cash flow rights and protective features such as floating conversion prices, Chaplinsky and Haushalter found that the “all-in net purchase discount”⁴¹ for PIPE deals ranges from 14.3% to 34.7%.⁴²

Not surprisingly, PIPE issuers continue to perform poorly following PIPE financings.⁴³ Chaplinsky and Haushalter found negative abnormal returns to existing shareholders of PIPE issuers of -16% after twelve months (with a median of -43%) and -33% after twenty-four months (with a median of -70%).⁴⁴ Additionally, the stock of 28-percent of issuers was delisted within twenty-four months following the PIPE financing.⁴⁵

D. PIPE Investors

This dismal post-PIPE performance of course raises the question of who is investing in PIPEs. The answer is hedge funds.⁴⁶ They constitute nearly 80% of the investors in micro-cap PIPEs.⁴⁷ Hedge funds invest for the obvious reason: their returns from PIPE investments meet or beat market benchmarks.⁴⁸ Chaplinsky and Haushalter estimated PIPE

³⁷ See *id.* at 8.

³⁸ *Id.* at 11.

³⁹ *Id.* at 12. (“In sum the pervasive nature of poor pre-issue operating and stock performance, as well as their generally small size, suggests that PIPE issuers are not candidates for debt financing or follow-on stock financing”)

⁴⁰ See *id.* at 3.

⁴¹ Chaplinsky & Haushalter, *supra* note 4, at 16 (Estimated value of PIPE securities at time of issuance relative to amount invested.).

⁴² See *id.* at 3-4.

⁴³ *Id.* at 3.

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.* at 8. See also Brophy, *supra* note 5, at 10.

⁴⁷ Carolyn Sargent, *Squeezing the PIPEs*, ABSOLUTE RETURN 12 (Feb. 2007). See also Carol E. Curtis, As Hedge Funds Invest in Pipes, SEC Steps Up Scrutiny, SECURITIES INDUSTRY NEWS 12 (Oct. 23, 2006) (noting that “hedge funds seeking discounted securities are the largest group of investors in [PIPEs],” and that the top ten PIPE investors by number of deals in 2006 (through October) were all hedge funds).

⁴⁸ See Chaplinsky & Haushalter, *supra* note 4, at 4. See also Brophy, *supra* note 5, at 4.

investors' excessive returns using various benchmarks and found that "from three to twelve months post-issue, average returns consistently exceed benchmark returns, often by double digits."⁴⁹

Hedge funds are able to obtain these returns notwithstanding the poor performance of PIPE issuers through a relatively straightforward trading strategy. They sell short the issuer's common stock promptly after the PIPE deal is publicly disclosed.⁵⁰ To execute a short sale, a fund borrows stock of the PIPE issuer from a broker-dealer and sells this borrowed stock into the market.⁵¹ The fund then closes out or covers the short sale at a later date by buying shares in the open market and delivering them to the lender.⁵² By shorting stock against the PIPE shares, the fund locks in the PIPE deal purchase discount.⁵³ With a traditional PIPE, if the market price of the issuer's common stock drops below the discounted price following a PIPE transaction, the fund will take a loss on the PIPE shares, but this loss will be exceeded by gains realized when it closes out its short position because it will be able to buy shares in the market to cover the position at a lower price than it earlier sold the borrowed shares. If the market price of the issuer's common stock rises after the PIPE transaction, the fund will take a loss when closing out the short position because it will have to buy shares to cover the position at a higher price than it earlier sold the borrowed shares. This loss, however, will be exceeded by an increase in the value of the PIPE shares since they were purchased at a discount to the pre-rise market price.⁵⁴

For example, say an issuer negotiates a traditional PIPE deal for the sale of \$1,000,000 of common stock to a hedge fund at a 15% discount to market price. The issuer then discloses the deal to the market and its stock drops from \$11.00 to \$10.00 per shares. Shortly thereafter, the parties close the private placement, the fund wires \$1,000,000 to the issuer, the issuer issues 117,647 shares of common stock to the fund (\$1,000,000 divided by \$8.50), and the fund sells short 117,647 shares of the issuer's common stock at an average price of \$9.50 or \$1,117,646.50 in the aggregate. Three months later, the PIPE resale registration statement is declared effective and the fund unwinds its position, i.e., it sells its PIPE shares at the prevailing market price of say \$7.00 per share and covers its short position at \$7.00

⁴⁹ Chaplinsky & Haushalter, *supra* note 4, at 4.

⁵⁰ See Steve Winters, *Managing Risk: Securities Structures, Trading and Documentation, PIPEs: A Guide to Private Investments in Public Equity Revised and Updated Edition* 205, 212 (2006).

⁵¹ See James W. Christian et al., *Naked Short Selling: How Exposed are Investors?*, 43 HOUS. L. REV. 1033, 1041 (2006). See also 17 C.F.R. § 242.200(a) (2006) ("The term *short sale* shall mean any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.").

⁵² See Christian, *supra* note 51, at 1041-42.

⁵³ See Chaplinsky & Haushalter, *supra* note 4, at 18.

⁵⁴ See *id.* at 18-19.

per share resulting in the following profit on the transaction, excluding transaction fees (legal fees, brokerage commissions, etc.).

| | |
|------------------------------------|------------------|
| Initial Investment | <\$1,000,000.00> |
| Proceeds from short sales | \$1,117,646.50 |
| Proceeds from sales of PIPE shares | \$823,529.00 |
| Cost to cover short position | <\$823,529.00> |
| Profit | \$117,646.50 |
| 90-day return | 11.76% |
| Annualized return | 47.04% |

The above example assumes, among other things, that the fund will be able to sell its PIPE shares and cover its short position at the same price per share, likely an unrealistic assumption.⁵⁵ However, even if the fund covered its short position at \$7.00 per share and sold its PIPE shares at \$6.50 per share, it would still make \$58,823.50 on the deal, yielding a 90-day return of 5.88% and an annualized return of 23.53%.

The strategy can be even more profitable for hedge funds in a structured PIPE deal with a floating conversion price. If the issuer's stock price drops, a fund profits on its short sales dollar for dollar. At the same time, it also profits on the PIPE shares because the conversion price of the PIPE securities is based on a discount to market price on the date of conversion, i.e., the conversion price floats down with the market price. Hence, the fund makes money on both sides of the trade, subject only to unwinding risk.⁵⁶

For example, say an issuer negotiates a structured PIPE deal for the sale of a \$1,000,000 convertible note to a hedge fund. The note bears interest at 10% per annum and provides that the principal amount and interest is convertible at the holder's option into the issuer's common stock at 85% of the per share market price on the date of conversion. The issuer then discloses the deal to the market and its stock drops from \$11.00 to \$10.00 per share. Shortly thereafter, the parties close the private placement, the fund wires \$1,000,000 to the issuer, the issuer issues the note, and the fund sells short 117,647 shares of the issuer's common stock at an average prices of \$9.50 or \$1,117,646.50 in the aggregate. Three months later, the PIPE resale registration statement is declared effective at which time the issuer's stock is trading at \$7.00 per share. The fund converts the note into 173,669 shares of common stock based on \$5.95 conversion price (85% of \$7.00),⁵⁷ sells these shares into the market at \$7.00 per share, and covers its

⁵⁵ This would be the case if the SEC allowed an investor to cover short sales with PIPE shares, but, as discussed below, it does not. See *infra* text accompanying notes 140-46.

⁵⁶ See *id.*

⁵⁷ $(\$1,000,000.00 \text{ principal amount} + \$33,333.33 \text{ in interest}) / \$5.95 = 173,669$

short position at \$7.00 per share resulting in the following profit on the transaction, excluding transaction fees.

| | |
|------------------------------------|------------------|
| Initial Investment | <\$1,000,000.00> |
| Proceeds from short sales | \$1,117,646.50 |
| Proceeds from sales of PIPE shares | \$1,215,683.00 |
| Cost to cover short position | <\$823,529.00> |
| Profit | \$509,800.50 |
| 90-day return | 50.98% |
| Annualized return | 203.92% |

This strategy is obviously dependent on a fund being able to borrow shares to sell short. For a variety of reasons, however, there is often a limited supply of PIPE issuer shares available in the equity lending market.⁵⁸ Thus, a fund may not be able to borrow enough shares to fully lock in the discount through standard short sales. Some funds, however, have allegedly dealt with this issue by engaging in naked short selling.⁵⁹ A naked short sale is simply the sale of shares for the account of an investor who neither owns nor has borrowed the shares.⁶⁰ Naked short selling is not necessarily illegal but may constitute illegal stock manipulation, depending on intent.⁶¹

In addition to short selling, many hedge funds retain upside potential by negotiating for warrants as part of a PIPE transaction.⁶² Hedge funds typically hold on to these warrants even after unwinding their PIPE shares positions so that they can profit further in the event the issuer's stock happens to rise above the warrant exercise price. In sum, hedge funds are able to garner superior returns through PIPE investments because they purchase the PIPE shares at a substantial discount to market, manage their downside risk through short sales and floating conversion prices, retain upside potential through warrants, and liquidate their positions a relatively short time after closing on the private placement.⁶³

III. SECURITIES LAW COMPLIANCE

⁵⁸ See Chaplinsky & Haushalter, *supra* note 4, at 19. Among the reasons are lower levels of institutional ownership (institutions are frequently the source of stock loans) and brokerage firm restrictions on buying penny stock (stocks trading at \$5 or less) on margin (brokerage firms frequently lend out stock held in margin accounts). See *id.*

⁵⁹ See, e.g., Complaint, SEC v. Spiegel, Inc., No. 03C-1685, 2003 U.S. Dist. 17933 (N.D. IL 2003) at 6 *available at* <http://www.sec.gov/litigation/complaints/comp18020.htm>.

⁶⁰ See Christian, *supra* note 51, at 1044.

⁶¹ See *id.* at 1046.

⁶² See Chaplinsky & Haushalter, *supra* note 4, at 16.

⁶³ See *id.* at 14; Brophy, *supra* note 5, at 4 (“[B]eing an investor of last resort pays off.”).

PIPE transactions raise a number of legal issues. This section discusses compliance with federal and state securities laws and NASDAQ listing requirements.

A. Federal Securities Laws

The Securities Act of 1933 requires that every offer and sale of a security either be registered with the SEC or qualify for an exemption from registration.⁶⁴ A PIPE involves two offerings—an exempt or private offering by the issuer to the PIPE investors and a registered or public offering by the PIPE investors to the public. This part discusses federal securities law compliance for these two offerings.

1. Private Offering

A private offering, by definition, is conducted in compliance with an exemption from registration as opposed to being registered with the SEC. The Securities Act and rules promulgated thereunder contain a number of registration exemptions. PIPE issuers generally rely on the exemption provided by Section 4(2) of the Securities Act.⁶⁵ Section 4(2) exempts from registration “transactions by an issuer not involving any public offering.”⁶⁶ Thus, the application of Section 4(2) turns on the definition of “public offering,” but the Securities Act does not define the term.⁶⁷ The SEC has, however, promulgated Rule 506, which serves as a Section 4(2) “safe harbor,” i.e., if a private offering complies with the conditions specified in Rule 506, the offering will be deemed exempt under Section 4(2).⁶⁸

To fall within the safe harbor, the offering must be limited to accredited investors and no more than 35 non-accredited investors.⁶⁹ Virtually all hedge funds and the like qualify as accredited investors because Rule 501(a) defines “accredited investor” as, among other things, any business “not formed for the specific purposed of acquiring the

⁶⁴ See 15 U.S.C. § 77e(a) (2006). See generally LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § 2-B (3d ed. 1989).

⁶⁵ Tanenbaum & Pinedo, *supra* note 10, at 93.

⁶⁶ 15 U.S.C. § 77d(2) (2006).

⁶⁷ See William K. Sjostrom, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 35 (2004).

⁶⁸ 17 C.F.R. § 230.506(a) (2006) (“Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of this Rule 506 shall be deemed to be a transaction not involving any public offering within the meaning of section 4(2) of the [Securities] Act.”).

⁶⁹ 17 C.F.R. §§ 230.506(b)(2)(i) & 501(e) (2006).

securities offered, with total assets in excess of \$5,000,000.”⁷⁰ The issuer has to furnish any non-accredited investors that purchase securities in the offering certain specified information about the issuer and the offering a reasonable time prior to the purchase and has to reasonably believe that all non-accredited investors are sophisticated, either alone or with their purchaser representatives.⁷¹ Typically, PIPE deals are marketed only to accredited investors so that the issuer does not have to contend with meeting these disclosure and sophistication requirements.⁷²

Neither the issuer nor anyone acting on its behalf can solicit investors in an offering made in reliance on Rule 506 through any form of “general solicitation” or “general advertising.”⁷³ For a communication to a potential investor not to be considered general solicitation or advertising, the SEC requires a pre-existing, substantive relationship between the solicitor and potential investor.⁷⁴ The SEC considers a relationship pre-existing if it is established prior to the solicitation for the particular offering.⁷⁵ The SEC considers a relationship substantive if it “would enable the issuer (or a person acting on its behalf) to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or that otherwise are of some substance and duration.”⁷⁶

The only filing required to be made with the SEC for a Rule 506 offering is a nine page Form D setting forth some basic information about the offering.⁷⁷ The company must file the Form D no later than fifteen days after the first sale of securities.⁷⁸ Securities issued in reliance on Rule 506 are considered “restricted securities.”⁷⁹ This means a PIPE investor cannot

⁷⁰ 17 C.F.R. § 230.501(a)(3) (2006).

⁷¹ 17 C.F.R. § 230.502(b)(1) (2006). While Rule 502(b)(1) does not require that any information be furnished to accredited investors in a Rule 505 or 506 offering, Rule 502(b)(1) includes a note that provides as follows: “When an issuer provides information to investors pursuant to paragraph (b)(1), it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws.” *Id.*

⁷² See Steven Dresner & Brett Goetschius, *The Players: Issuers, Investors, Agents and Regulators*, in *PIPES: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY* 65, 70 (rev. & updated ed. 2006).

⁷³ 17 C.F.R. §§ 230.506(b)(1) & 230.502(c) (2006).

⁷⁴ See LOSS & SELIGMAN, *supra* note 64, at § 3-C-6(b)(iv)(1). See also Robert T. Willis, Jr., P.C., SEC No-Action Letter, 1988 SEC No-Act. LEXIS 34 at *2 (Jan. 18, 1988).

⁷⁵ See E.F. Hutton & Co., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2917 at *2 (Dec. 3, 1985).

⁷⁶ Mineral Lands Research & Mktg. Corp., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2811 at *2 (Dec. 4, 1985).

⁷⁷ 17 C.F.R. §§ 230.503 & 239.500 (2006).

⁷⁸ 17 C.F.R. § 230.503(a) (2006).

⁷⁹ See 17 C.F.R. §§ 230.144(a)(3)(ii) & 230.502(d) (2006).

generally sell the PIPE shares for at least one year from the closing of the PIPE, unless the subsequent sale is registered with the SEC.⁸⁰

2. Public Offering

As mentioned above, PIPE deals include a requirement that the issuer file a registration statement with respect to the resale or secondary offering of the PIPE shares. The issuer typically registers the resale on Form S-3 under the Securities Act unless it does not meet the eligibility requirements of the form. Form S-3 is an abbreviated registration form which allows a public company to incorporate by reference the information contained in its existing and future quarterly, annual and other reports it is required to file with the SEC under the Securities Exchange Act of 1934 (“Exchange Act”).⁸¹ This means that a great deal of information about the company is not actually set forth in the registration statement but instead the registration statement contains a cross reference to the company’s Exchange Act reports.⁸² As a result of incorporation by reference, frequently a Form S-3 prospectus will be quite short, containing only very abbreviated financial and business disclosure about the issuer.⁸³

To be eligible to use Form S-3 for a secondary offering, among other things, a company must have been a reporting company for at least the previous year and have filed all Exchange Act reports timely during the previous year.⁸⁴ Additionally, the company must (1) have securities of the same class as those being registered “listed and registered on a national securities exchange or . . . quoted on the automated quotation system of a national securities association;”⁸⁵ or (2) have a common stock public float of at least \$75 million.⁸⁶ Many PIPE issuers, however, fail to meet the first requirement because their shares are listed on the OTC Bulletin Board or

⁸⁰ 17 C.F.R. §§ 230.506(b)(1) & 230.502(d) (2006).

⁸¹ See CHARLES J. JOHNSON, JR. & JOSEPH McLAUGHLIN, *CORPORATE FINANCE AND THE SECURITIES LAWS* § 3.02[C] (4th ed. 2006).

⁸² See *id.*

⁸³ See Committee on Federal Regulation of Securities, *Report of Task Force on Sellers’ Due Diligence and Similar Defenses Under the Federal Securities Laws*, 48 BUS. LAW. 1185, 1219 n.153 (1992-1993). See also Johnson & McLaughlin, *supra* note 81, at § 3.02[C].

⁸⁴ See 17 C.F.R. § 239.13(a)(3) (2006).

⁸⁵ See 17 C.F.R. § 239.13(b)(3) (2006).

⁸⁶ See 17 C.F.R. § 239.13(b)(1) (2006). See also DIVISION OF CORPORATE FINANCE, SEC. & EXCH. COMM’N, *MANUAL OF PUBLICLY AVAILABLE TELEPHONE INTERPRETATIONS, SECURITIES ACT FORM S-3*, at § H.56 (1997) [hereinafter, SEC TELEPHONE INTERPRETATIONS MANUAL], available at <http://www.sec.gov/interps/telephone.shtml>, which provides: “Issuers meeting the float test in General Instruction I.B.1 of Form S-3 may make secondary offerings on Form S-3, even though the securities to be issued are not listed on a national securities exchange or quoted on an automated quotation system of a national securities association, as required by General Instruction I.B.3.”

the Pink Sheets, and the SEC has stated that these markets do not fall within the authorized exchanges or quotation systems.⁸⁷ Further, many PIPE issuers do not have a sufficient public float to meet the second requirement.

If a company is ineligible to use Form S-3, it will have to register the resale on Form S-1, or, if the company qualifies as a “small business issuer,”⁸⁸ it may choose to use Form SB-2.⁸⁹ Both of these forms are considered full-blown registration statements, i.e., much more information is actually set forth in the registration statement as compared to a registration statement on Form S-3.⁹⁰ The use of Form S-1 or SB-2 will likely result in higher transaction costs for a PIPE issuer as compared to a registration statement on Form S-3. Because these forms call for more elaborate disclosure, they take more time and effort to prepare, which results in higher professional fees. Additionally, the SEC is more likely to review an S-1 or SB-2 registration statement, which would further delay effectiveness. Hence, PIPE investors will likely demand an additional discount or higher penalty to compensate them for (1) the fact that, as compared to an S-3, it will take longer for the company to file the registration statement, and (2) the greater risk that effectiveness will be delayed by SEC review.

It should be noted that the resale registration statement for a PIPE will be filed as a shelf registration statement under Securities Act Rule 415.⁹¹ Rule 415 allows a registration statement to cover sales that will be made over a period of time.⁹² This will provide investors with the

⁸⁷ See *id.* § H.54 (“For purposes of General Instruction I.B.3. of Form S-3, ‘quoted on the automated quotations system of a national securities association’ includes listing on the NASDAQ small cap market [predecessor of the NASDAQ Capital Market] and listing on the NASDAQ National Market System [predecessor of the NASDAQ Global Market], but does not include listing on the NASDAQ electronic bulletin board.”)

⁸⁸ A small business issuer is any entity with revenue of less than \$25 million during its last fiscal year and a public float (shares held by non-affiliates of the entity) with a market value of less than \$25 million and that is not a foreign (other than Canadian) private company, an investment company or a majority-owned subsidiary of a non-small business company. 17 C.F.R. §§ 230.405 & 228.10(a) (2006).

⁸⁹ Form SB-2 is less burdensome to comply with than Form S-1. Specifically, the requirements with respect to financial statements are more easily met than are those for Form S-1 and permit use of financial statements prepared in accordance with generally accepted accounting principles, whereas Forms S-1 requires financial statements to be prepared in accordance with the detailed requirements of Regulation S-X, 17 C.F.R. §§ 210.1-01 through 210.12-29 (2006).

⁹⁰ It should be noted that since December 2005, Form S-1 has allowed certain issuers to incorporate by reference information from their Exchange Act reports. See 70 Fed. Reg. 44819 (Aug. 3, 2005). Many PIPE issuers, however, do not meet the eligibility requirements to use incorporation by reference because during the last three years it was either a blank check company, a shell company, or registered a penny stock offering. See Form S-1, Gen. Instr. VII.

⁹¹ See 17 C.F.R. § 230.415 (2006).

⁹² See Johnson & McLaughlin, *supra* note 81, at § 8.01.

flexibility to sell their PIPE shares into the market over an extended period of time. Generally for a PIPE shares registration statement to qualify under Rule 415, the registration statement must pertain only to “[s]ecurities which are to be offered or sold solely by or on behalf of a person or persons other than the registrant, a subsidiary of the registrant or a person of which the registrant is a subsidiary.”⁹³

3. Integration

Under the concept of integration, two or more offerings which an issuer structured as separate exempt offerings may be “integrated” or treated by the SEC as one larger offering for which no exemption is available.⁹⁴ Integration is generally intended to prevent an issuer from circumventing the registration requirements of the Securities Act by structuring a large offering for which no exemption is available as two or more smaller exempt offerings.⁹⁵ If the SEC integrates a series of apparently exempt offerings, the integrated offering must qualify for an exemption.⁹⁶ If it does not, since by definition the integrated offering was not registered, all sales in connection therewith will have been made in violation of Section 5 of the Securities Act⁹⁷ resulting in, among other things, each purchaser in the offering having a right to rescind the transaction.⁹⁸

Integration is relevant to a PIPE deal because the deal involves a private placement followed shortly thereafter by a public offering. If these two offerings were integrated and treated as one larger offering, the issuer would be in violation of Section 5 of the Securities Act.⁹⁹ Rule 506 would not exempt the larger offering because the public offering component involved general solicitation.¹⁰⁰ The registration statement does not save a violation because it covers the resale of the underlying securities by the PIPE investors and not the issuance of the PIPE securities to the investors. Hence, the integrated offering is neither fully registered nor exempt, and therefore violates section 5.

Fortunately for the PIPE issuers, integration issues are easy to manage because of Securities Act Rule 152.¹⁰¹ Rule 152 dates back to 1935

⁹³ *Id.* See also 17 C.F.R. § 230.415(a)(1)(i) (2006).

⁹⁴ LOSS & SELIGMAN, *supra* note 64, at § 3-C-1.

⁹⁵ *Id.*; Cheryl L. Wade, *The Integration of Securities Offerings: A Proposed Formula that Fosters the Policies of Securities Regulation*, 25 LOY. U. CHI. L.J. 199, 209 (1994).

⁹⁶ *Id.* at 200.

⁹⁷ 15 U.S.C. § 77e (2006).

⁹⁸ 15 U.S.C. § 77l(a) (2006).

⁹⁹ See LOSS & SELIGMAN, *supra* note 64, at § 3-C-1.

¹⁰⁰ See 17 C.F.R. § 230.506(a) (2006).

¹⁰¹ See 17 C.F.R. § 230.152 (2006). See also Verticom Inc. No-Action Letter, 1986 WL 65214 (SEC states that a completed private placement would not be integrated with a contemplated registered public offering not because of the five integration factors but

and “makes clear that offerings made prior to the filing of the registration statement and made under circumstances which did not necessitate registration or contemplate registration, do not by the fact of registration become the type of offerings which are prohibited by the Securities Act.”¹⁰² Under SEC interpretations of the rule, as long as the private offering is completed prior to the filing of the registration statement for the secondary offering, the offerings will not be integrated even if the registration statement is filed shortly after closing of the private placement.¹⁰³

In fact, SEC interpretations allow an issuer to file a resale registration statement before closing the related private offering without integration concerns, provided the private offering meets each of the following three conditions:

1. The private offering investors are “irrevocably bound to purchase a set number of securities for a set purchase price that is not based on market price or a fluctuating ratio, either at the time of effectiveness of the resale registration statement or at any subsequent date.”¹⁰⁴
2. There are “no conditions to closing that are within an investor's control or that an investor can cause not to be satisfied.”¹⁰⁵ Examples of prohibited closing conditions include those “relating to the market price of the company's securities or the investor's satisfactory completion of its due diligence on the company”¹⁰⁶
3. “The closing of the private placement of the unissued securities must occur within a short time after the effectiveness of the resale registration statement.”¹⁰⁷

Hence, it is possible to structure a PIPE so that the PIPE investors' obligations to close on the private placement are conditional on the effectiveness of the resale registration statement for the underlying common

instead because “under Rule 152 the filing of a registration statement following an offering otherwise exempt under Section 4(2) does not vitiate the exemption under Section 4(2).”)

¹⁰² Securities Act Release No. 305, 1935 WL 28674 (Mar. 2, 1935). The rule provides: “the phrase ‘transactions by an issuer not involving any public offering’ used in Section 4(2) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement.” 17 C.F.R. § 230.152 (2006).

¹⁰³ See *Vulture Petroleum Corp.*, SEC No-Action Letter, 1987 WL 107524 (Feb. 2, 1987). See also SEC TELEPHONE INTERPRETATIONS MANUAL, *supra* note 86 (3d Supp. Mar. 1999), at § 3S(a).

¹⁰⁴ *Id.* at §35b.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

stock; having the SEC declare a resale registration statement effective is considered outside the control of the PIPE investors.¹⁰⁸

B. State Securities Laws

As a general matter, anyone offering or selling securities must also comply with the securities laws of the states in which they are making the offers and sales, all of which, except for the state of New York, require registration of the offering with state regulators unless the offering falls within an exemption therefrom.¹⁰⁹ In 1996, however, Congress passed the National Securities Markets Improvement Act (“NSMIA”).¹¹⁰ NSMIA, among other things, amended Section 18 of the Securities Act to provide that no state law, rule, regulation, or order “requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that is a covered security”¹¹¹ The definition of a covered security includes a security issued pursuant to Rule 506¹¹² so blue sky compliance is a non-issue for the private placement component of a PIPE.

Similarly, blue sky compliance is generally a non-issue for the public offering component as well. There would be no violation because most states exempt from their registration requirements secondary resales of securities if the issuer has been subject to the reporting requirements under the Exchange Act for at least 90 days.¹¹³

C. NASDAQ Rules

Companies listed on NASDAQ are required to comply with the NASDAQ Marketplace Rules or face delisting.¹¹⁴ Several of these rules may be implicated by a PIPE transaction, especially a transaction involving structured PIPE securities (what NASDAQ refers to as “Future Priced Securities”).¹¹⁵ In particular, Rule 4350(i)(1)(D) provides in part:

¹⁰⁸ DENNIS T. RICE & CHARLES P. ORTMAYER, SECURITIES REGULATION FORMS § 14:94 B (2007), available at SECREGFRM S 14:94 (Westlaw).

¹⁰⁹ Loss & Seligman, *supra* note 59, at § 1-B-4.

¹¹⁰ National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified in scattered sections of 15 U.S.C.). See generally LOSS & SELIGMAN, *supra* note 64, at § 1-B-3.

¹¹¹ 15 U.S.C. § 77r(a)(1) (2006).

¹¹² 15 U.S.C. § 77r(b)(4)(D) (2006) (Rule 506 was issued by the SEC under section 4(2)). See 17 C.F.R. § 230.506(a) (2006).

¹¹³ See Unif. Securities Act § 402(2) (1985).

¹¹⁴ See NASDAQ, Inc., Manual §§ 4000-7000 (2006), available at <http://nasdaq.complinet.com/nasdaq/display/index.html> [hereinafter NASDAQ Manual].

¹¹⁵ *Id.* at IM-4350-1. It should be noted that the NYSE and AMEX likewise have rules implicated by PIPE transactions. See Tanenbaum & Pinedo, *supra* note 10, at 113-14.

Each issuer shall require shareholder approval prior to the issuance of securities in connection with a transaction other than a public offering involving the sale, issuance or potential issuance by the issuer of common stock (or securities convertible into or exercisable for common stock) at a price less than the greater of book or market value which together with sales by officers, directors or substantial shareholders of the company equals 20% or more of the common stock or 20% or more of the voting power outstanding before the issuance.¹¹⁶

With a structured PIPE, the number of shares to be issued in the future is indeterminate because it depends on the market price at the time of conversion. As a result, in applying the above rule, NASDAQ looks to “the maximum potential issuance of common shares at the time the Future Priced Security is issued.”¹¹⁷ For some structured PIPES (the “death spiral” variety), the issuance of the PIPE security without shareholder approval will likely violate Rule 4350(i)(1)(D). There would be a violation because in applying the 20% threshold NASDAQ will use a conversion price of one cent given that the market price of the company’s common stock, and therefore the PIPE security conversion price, could potentially drop that low.¹¹⁸

An issuer can include features in its structured PIPE to avoid triggering the shareholder approval requirement of Rule 4350(i)(1)(D). For example, the number of shares of common stock issuable upon conversion could be capped at 20% or less,¹¹⁹ “such that there cannot, under any circumstances, be an issuance of 20% or more of the common stock or voting power previously outstanding without prior shareholder

Few PIPE issuers, however, have securities listed on these exchanges. Thus, this article does not discuss NYSE and AMEX rules.

¹¹⁶ *Id.* at R. 4350(i)(1)(D) (2006). Note that “NASDAQ may make exceptions to this requirement when the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise and reliance by the company on this exception is expressly approved by the Audit Committee or a comparable body of the Board of Directors.” *Id.*, IM-4350-1, at n. 1.

¹¹⁷ NASDAQ Manual, *supra* note 114 at IM-4350-1.

¹¹⁸ As NASDAQ put it: “Typically, with a Future Priced Security, the maximum potential issuance will exceed 20 percent of the common stock outstanding because the Future Priced Security could, potentially, be converted into common stock based on a share price of one cent per share, or less. Further, for purposes of this calculation, the lowest possible conversion price is below the book or market value of the stock at the time of issuance of the Future Priced Security. Therefore, shareholder approval must be obtained prior to the issuance of the Future Priced Security. Issuers should also be cautioned that obtaining shareholder ratification of the transaction after the issuance of a Future Priced Security does not satisfy the shareholder approval requirements.” *Id.*

¹¹⁹ See NASDAQ Manual, *supra* note 114.

approval.”¹²⁰ Additionally, a floor could be placed on the conversion price at the greater of book or market value of the company’s common stock on the issuance date of the PIPE security.¹²¹ NASDAQ warns, however, that even if a structured PIPE contains these features “shareholder approval is still required under Rule 4350(i)(1)(B)¹²² if the issuance will result in a change of control.”¹²³

A PIPE issuance may also implicate NASDAQ Rule 4351 which provides: “Voting rights of existing shareholders of publicly traded common stock registered under Section 12 of the [Exchange] Act cannot be disparately reduced or restricted through any corporate action or issuance.”¹²⁴ NASDAQ interprets this provision to mean that “an issuer cannot create a new class of security that votes at a higher rate than an existing class of securities or take any other action that has the effect of

¹²⁰ NASDAQ Manual, *supra* note 114, at IM-4350-2. With respect to such a cap, NASDAQ notes: “If an issuer determines to defer a shareholder vote in this manner, shares that are issuable under the cap (in the first part of the transaction) must not be entitled to vote to approve the remainder of the transaction. In addition, a cap must apply for the life of the transaction, unless shareholder approval is obtained. For example, caps that no longer apply if a company is not listed on NASDAQ are not permissible under the Rule. Of course, if shareholder approval is not obtained, then the investor will not be able to acquire 20% or more of the common stock or voting power outstanding before the transaction and would continue to hold the balance of the original security in its unconverted form.

NASDAQ has observed situations where issuers have attempted to cap the issuance of shares at below 20% but have also provided an alternative outcome based upon whether shareholder approval is obtained, such as a “penalty” or a “sweetener.” For example, a company issues a convertible preferred stock or debt instrument that provides for conversions of up to 20% of the total shares outstanding with any further conversions subject to shareholder approval. However, the terms of the instrument provide that if shareholders reject the transaction, the coupon or conversion ratio will increase or the issuer will be penalized by a specified monetary payment. Likewise, a transaction may provide for improved terms if shareholder approval is obtained. NASDAQ believes that in such situations the cap is defective because the related penalty or sweetener has a coercive effect on the shareholder vote, and thus may deprive shareholders of their ability to freely exercise their vote. Accordingly, NASDAQ will not accept a cap that defers the need for shareholder approval in such situations. Instead, if the terms of a transaction can change based upon the outcome of the shareholder vote, no shares may be issued prior to the approval of the shareholders. Issuers that engage in transactions with defective caps may be subject to delisting.” *Id.*

¹²¹ NASDAQ Manual, *supra* note 115, IM-4350-1.

¹²² NASDAQ Manual R. 4350(i)(1)(B) requires shareholder approval of a securities issuance “when the issuance or potential issuance will result in a change of control of the issuer.” *Id.*, R. 4350(i)(1)(B). For a discussion of the definition of “change of control” as used in the rule, see Deborah A. Marshall & Julia Vax, *NASDAQ Compliance Issues in PIPE Transactions*, 35TH ANNUAL INSTITUTE ON SECURITIES REGULATION, at 144-45 (PLI Corporate Law Practice, Course Handbook Series No. B0-01PG, 2003) (Westlaw 1396 PLI/Corp 133).

¹²³ NASDAQ Manual, *supra* note 114, IM-4350-1.

¹²⁴ *Id.*, R. 4351.

restricting or reducing the voting rights of an existing class of securities.”¹²⁵ NASDAQ notes that structured PIPE securities implicate the provision when they allow holders to vote on an as-converted basis or elect members of the board of directors.¹²⁶ In particular:

[NASDAQ] will consider whether a voting rights violation exists by comparing the Future Priced Security holders' voting rights to their relative contribution to the company based on the company's overall book or market value at the time of the issuance of the Future Priced Security. The percentage of the overall vote attributable to the Future Priced Security holders and the Future Priced Security holders' representation on the board of directors must not exceed their relative contribution to the company based on the company's overall book or market value at the time of the issuance of the Future Priced Security. If the voting power or the board percentage exceeds that percentage interest, a violation exists because a new class of securities has been created that votes at a higher rate than an already existing class. Future Priced Securities that vote on an as-converted basis also raise voting rights concerns because of the possibility that, due to a decline in the price of the underlying common stock, the Future Priced Security holder will have voting rights disproportionate to its investment in the Company.¹²⁷

It is obvious that NASDAQ generally disapproves of death spiral PIPEs and therefore has interpreted its rules accordingly.

IV. RECENT SEC PIPE ENFORCEMENT ACTIONS

Considering the popularity of PIPE investments among hedge funds, some of which routinely push the legal envelope with their trading strategies, it is not surprising that the SEC has uncovered a number of PIPE investors that have engaged in some questionable practices. In the last two years, the SEC has brought at least eleven enforcement actions relating to PIPE deals.¹²⁸ Most of these actions involve claims that the defendants engaged in insider trading and/or violated Section 5 of the Securities Act.

¹²⁵ *Id.*, IR-4350-1 at *2.

¹²⁶ *See id.*

¹²⁷ *Id.* NASDAQ notes that shareholder approval of an issuance does not affect compliance with the voting rights rule.

¹²⁸ Complaint, SEC v. Zehil, No. 07cv1439 (S.D.N.Y. Filed Feb. 28, 2007) *available at* <http://www.sec.gov/litigation/complaints/2007/comp20021.pdf>; Complaint, Spiegel, *supra* note 55; Complaint, SEC v. Friedman, No. 06-cv-02160 (D.D.C. filed Dec. 20, 2003) *available at* <http://www.sec.gov/litigation/complaints/2006/comp19950.pdf>;

A. Insider Trading

The SEC has leveled insider trading allegations against defendants that sold short shares of PIPE issuers in the open market *prior* to public disclosure of the PIPE financing.¹²⁹ Under the misappropriation theory of insider trading, a person violates Section 10(b) of the Exchange Act and Rule 10b-5 thereunder “when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.”¹³⁰ To prevail on an insider trading claim under the misappropriation theory, the SEC must prove that the defendant traded on material, non-public information in breach of a duty of trust or confidence owed by the defendant to the information source.¹³¹

Information is considered material with respect to insider trading if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.¹³² Put differently, “there must be a substantial likelihood that the disclosure of the [information] would have been viewed by the reasonable investor as having significantly altered

Complaint, SEC v. Margan, No. 06-0531 (W.D.N.C. filed Dec. 28, 2006) *available at* <http://www.sec.gov/litigation/complaints/2006/comp19955.pdf>; In re Dreyer, SEC Order, Securities Act Release No. 8761, Exchange Act Release No. 54972 (Dec. 20, 2006) *available at* <http://www.sec.gov/litigation/admin/2006/33-8761.pdf>; In re Spinner Asset Management, LLC, SEC Order, Securities Act Release No. 8763, Investment Advisers Act Release No. 2573 (Dec. 20, 2006) *available at* <http://www.sec.gov/litigation/admin/2006/33-8763.pdf>; Complaint, SEC v. Lyon, (S.D.N.Y. filed Dec. 12, 2006) *available at* <http://www.sec.gov/litigation/complaints/2006/comp19942.pdf>; Complaint, SEC v. Deephaven Capital Management, LLC, No. 1:06CV00805 (D.D.C. filed May 2, 2006) *available at* <http://www.sec.gov/litigation/complaints/2006/comp19683.pdf>; Complaint, SEC v. Langley Partners, L.P., No. 1:06CV00467 (D.D.C. filed March 14, 2006) *available at* <http://www.sec.gov/litigation/complaints/comp19607.pdf>; Complaint, SEC v. Shane, No. 05-CV-4772 (S.D.N.Y. filed May 18, 2005) *available at* <http://www.sec.gov/litigation/complaints/comp19227.pdf>; Complaint, SEC v. Pollet, No. 05-CV-1937 (E.D.N.Y. filed April 21, 2005) *available at* <http://www.sec.gov/litigation/complaints/2007/comp19984.pdf>.

¹²⁹ See, e.g., Complaint, Friedman, *supra* note 121, at 2; Complaint, Mangan, *supra* note 128, at 1; Complaint, Lyon, *supra* note 128, at 6; Complaint, Langley Partners, *supra* note 128, at 3; Complaint, Deephaven, *supra* note 128, at 1; Complaint, Shane, *supra* note 128, at 1; Complaint, Pollet, *supra* note 128, at 2.

¹³⁰ U.S. v. O'Hagan, 521 U.S. 642, 652 (1997).

¹³¹ *Id.* at 656.

¹³² TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (“An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”). TSC technically established the definition of “material fact” for purposes of Section 14a-9 of the Exchange Act which applies to misstatements or omissions in proxy solicitation materials. The Supreme Court subsequently adopted the same standard for Section 10 and Rule 10b-5. Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988).

the ‘total mix’ of information made available.”¹³³ Making a materiality determination is a fact intensive inquiry that “requires delicate assessments of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact.”¹³⁴ Note that in a 2000 release, the SEC specifically listed “private sales of additional securities” as an event “that should be reviewed carefully to determine whether [it is] material.”¹³⁵

A duty of trust or confidence is deemed to arise from any fiduciary or fiduciary like relationship such as an employer/employee, attorney/client, and doctor/patient relationship.¹³⁶ Outside of this context, Rule 10(b)(5)-2 under the Exchange Act is relevant.¹³⁷ Rule 10(b)(5)-2 “provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the ‘misappropriation’ theory of insider trading.”¹³⁸ Among other things, the rule provides that a duty of trust or confidence exists “[w]hensoever a person agrees to maintain information in confidence.”¹³⁹

The December 12, 2006 complaint filed by the SEC in the United States District Court for the Southern District of New York against Edwin Buchanan Lyon, IV, Gryphon Master Fund, L.P., and related entities provides a good example of the application of the misappropriation theory in the context of PIPE deals. According to the complaint, defendants engaged in illegal insider trading by selling short the securities of four PIPE issuers prior to the public announcements of their PIPE offerings.¹⁴⁰ The SEC alleged that information concerning the four PIPE offerings was material because “the announcement typically precipitates a decline in the price of a PIPE issuer’s securities due to the dilutive effect of the offering and the PIPE shares being issued at a discount to the then prevailing market price of the issuer’s stock.”¹⁴¹ Hence, “[a] reasonable investor would have considered information concerning each of the four PIPEs – including the date of the PIPE offering, the discounted price of the stock, and the number of shares issued – important to his or her investment decision and a

¹³³ *TSC Indus.*, *supra* note 132, at 449.

¹³⁴ *Id.* at 450. *See also Basic*, *supra* note 132, at 236.

¹³⁵ Selective Disclosure and Insider Trading, SEC Release No. 34-43154, 2000 WL 1201556 at *10 (Aug. 15, 2000).

¹³⁶ *See* DONALD C. LANGEVOORT, INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION § 6.6 (2006).

¹³⁷ 17 C.F.R. § 240.10b5-2 (2006).

¹³⁸ *Id.* Preliminary Note.

¹³⁹ *Id.* § 240.10b5-2(b)(1).

¹⁴⁰ Complaint, Lyon, *supra* note 128, at 15.

¹⁴¹ *Id.*

significant alteration of the total mix of information available to the public.”¹⁴²

The SEC alleged that the defendants owed a duty of trust or confidence to the PIPE issuers because defendants “received offering documents with language requiring them to maintain the information contained therein in confidence and/or to refrain from trading prior to the public announcement of the offering.”¹⁴³ Hence, the SEC appears to be asserting that the defendants agreed to keep information concerning the impending PIPE deals in confidence, and therefore, the requisite duty of trust or confidence is established under Rule 10(b)(5)-2.¹⁴⁴ The SEC alleged that defendants breached this duty when they sold short the issuers’ securities prior to each of the four PIPE deals being publicly announced.¹⁴⁵

B. Section 5 Violations

Section 5 of the Securities Act requires that every offer and sale of a security be registered with the SEC,¹⁴⁶ although a number of exemptions from registration are available.¹⁴⁷ The SEC has recently asserted Section 5 violations against several PIPE investors. The factual basis is functionally the same in all these cases, and *SEC v. Joseph J. Spiegel* provides a representative example.¹⁴⁸ Spiegel was the portfolio manager for a hedge fund that invested in several PIPE deals.¹⁴⁹ In three of these deals, Spiegel hedged the fund’s PIPE investment by selling short the PIPE issuers’ securities before the resale registration statements for the PIPE shares were

¹⁴² *Id.* at 15-16. The SEC makes similar assertions concerning materiality in the Friedman complaint (at 13), the Mangan complaint (at 8-9), the Deeplaven complaint (at 4), and the Shane complaint (at 7).

¹⁴³ Complaint, Lyon, *supra* note 128, at 16.

¹⁴⁴ See 17 C.F.R. § 240.10b5-2(b)(1) (2006). The SEC makes similar assertions concerning the duty of trust or confidence in the Deeplaven complaint (see p. 4), and the Shane complaint (see p. 9). In the Deeplaven complaint, the SEC also attributes a duty of trust or confidence to Deeplaven because of a “pattern or practice” presumably as contemplated by Rule 10b5-2(b)(2) which provides as follows:

[A] “duty of trust or confidence” exists in the following circumstances, among others: Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality. § 240.10b5-2(b)(2) (2006).

¹⁴⁵ See *id.* at 18.

¹⁴⁶ 15 U.S.C. § 77e (2006).

¹⁴⁷ See, e.g., 15 U.S.C. § 77f (2006).

¹⁴⁸ See Complaint, Spiegel, *supra* note 59.

¹⁴⁹ *Id.* at 1.

declared effective.¹⁵⁰ Spiegel then covered some or all of these short sales with PIPE shares.¹⁵¹

The SEC views the short sales as Section 5 violations “because shares used to cover a short sale are deemed to have been sold when the short sale was made.”¹⁵² Hence, Spiegel, in effect, sold the PIPE shares into the market before registration statements for these sales were declared effective, thus violating Section 5.

The reason this constitutes a violation of Section 5 is somewhat convoluted. To begin with, the PIPE shares were issued in a transaction not involving a public offering and were therefore “restricted.”¹⁵³ Restricted securities can be sold only if registered with the SEC or an exemption from registration is available. Typically, resales of securities are exempt from registration under Section 4(1) of the Securities Act.¹⁵⁴ Section 4(1) exempts from registration “transactions by any person other than an issuer, underwriter, or dealer.”¹⁵⁵ In the SEC’s view, however, Section 4(1) is not available to Spiegel because he is an underwriter. Section 2(a)(11) of the Securities Act defines the term “underwriter”, among other things, as “any person who has purchased from an issuer with a view to . . . the distribution of any security.”¹⁵⁶ Under SEC interpretations, anyone who sells restricted securities is presumed to be an underwriter unless the sale is made in compliance with Securities Act Rule 144. Rule 144 sets forth conditions under which a person who sells restricted securities “shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter thereof within the meaning of Section 2(a)(11) of the [Securities] Act.”¹⁵⁷ Because Spiegel, in effect, sold the restricted shares (the PIPE shares) in an unregistered transaction and out of compliance with Rule 144, he is presumed to be an underwriter. Hence, Section 4(1) does not exempt the sales and neither does any other exemption. Thus, Spiegel violated Section 5 because the sales were neither registered nor exempt.¹⁵⁸

¹⁵⁰ *Id.* at 2.

¹⁵¹ *Id.* at 4.

¹⁵² *Id.*

¹⁵³ See 17 C.F.R. § 230.144(a)(3)(i) (2006).

¹⁵⁴ 15 U.S.C. § 77d(1) (2006).

¹⁵⁵ *Id.*

¹⁵⁶ 15 U.S.C. § 77b(a)(11) (2006).

¹⁵⁷ 17 C.F.R. § 230.144(b) (2006).

¹⁵⁸ Based on a similar line of reasoning, the SEC also alleged that Spiegel violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder which prohibits misrepresentations in connection with the purchase or sale of a security. Specifically, the SEC alleged that Spiegel signed several PIPE purchase agreements that included representations that the hedge fund was purchasing the shares for its own account and without the present intent to distribute the securities (this is a standard representation required of an investor in a private placement because it is essentially required for the issuances to be exempt from registration under Section 4(2) and Rule 506 of the Securities Act). The SEC’s position is that this constituted a misrepresentation

This line of reasoning rests on characterizing Spiegel's pre-effectiveness short sales as sales of PIPE shares. Such a characterization makes sense in Spiegel's case because he allegedly "executed 'naked' short sales by, among other things, selling short without borrowing unrestricted shares to deliver."¹⁵⁹ However, the analysis would be the same even if Spiegel had borrowed unrestricted shares to sell short. The SEC has long taken the position that a short sale cannot be covered with securities that were restricted on the date of the short sale.¹⁶⁰

It should be noted that a PIPE investor can sell short a PIPE issuer's securities before effectiveness of the resale registration so long as the short position is covered with shares purchased in the open market.¹⁶¹ As the SEC stated in a recent order from an administrative proceeding:

Many PIPE investors 'hedge' their investment by selling short the PIPE issuer's securities before the resale registration statement is declared effective. There is

because "Spiegel signed these securities purchase agreements despite knowing or recklessly not knowing that the hedge fund . . . had a present intention to distribute the PIPE securities through its short selling and to cover the PIPE shares in violation of Section." Complaint, Spiegel, *supra* note 59, at 8.

¹⁵⁹ *Id.* at 6.

¹⁶⁰ See Resales of Restricted and Other Securities, Release No. 6099, 1979 WL 174360 at *29 (Aug. 2, 1979), which provides:

(82) Question: Will a non-affiliate who sells securities short without placing his restricted securities "in the box" and later uses the restricted securities to cover the short position be able to rely on Rule 144 if he complies with its requirements only at the time the short position is covered?

Answer: No. It is necessary that the initial sales transaction comply with Rule 144. The purpose of this prohibition is to preclude a non-affiliate from avoiding the requirements of Rule 144(f) and (g) by effecting a short sale without complying with those sections and thereafter covering his short position with restricted securities.

This position was reaffirmed in Revision of Rule 144, Rule 145 and Form 144, Release No. 33-7391, 1997 WL 70601, at fn. 59 (Feb. 20, 1997). It is also consistent with the SEC's telephone interpretation manual which provides:

An issuer filed a Form S-3 registration statement for a secondary offering of common stock which is not yet effective. One of the selling shareholders wanted to do a short sale of common stock "against the box" and cover the short sale with registered shares after the effective date. The issuer was advised that the short sale could not be made before the registration statement becomes effective, because the shares underlying the short sale are deemed to be sold at the time such sale is made. There would, therefore, be a violation of Section 5 if the shares were effectively sold prior to the effective date. SEC TELEPHONE INTERPRETATIONS MANUAL, *supra* note 86, (Securities Act Sections, Jul. 1997) at § 65.

¹⁶¹ See HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, GOING PUBLIC AND THE PUBLIC CORPORATION § 6.31 (2006).

nothing per se illegal about ‘hedging’ a PIPE investment by selling short the issuer’s securities. Such short sales do not violate the registration provisions of the Securities Act if, among other things, the investor closes out the short position with shares purchased in the open market.¹⁶²

In this situation, the investor would still be viewed as selling the shares it used to cover the short position into the market on the date it effected the short sale. However, because these shares were purchased in the open market and are therefore unrestricted, the investor will not have violated Section 5; the sales will be exempt under Section 4(1) because the investor will not be considered an underwriter.

The SEC’s position may make sense conceptually. It does not, however, appear to further the policy behind Section 5. The policy behind Section 5 is “to provide investors with full disclosure of material information concerning public offerings of securities in commerce”¹⁶³ so that they can make informed investment decisions. To that end, Section 5 generally requires that all public offerings of securities be registered with the SEC and that each investor in the offering be furnished a prospectus.¹⁶⁴ Whether a PIPE investor covers short sales with PIPE shares or open market purchases has no impact on an issuer’s disclosure obligations. Disclosure regarding the resale of PIPE shares will be set forth in the resale registration statement, and this disclosure will be the same regardless of the type of shares used by a PIPE investor to cover a short position.

In the PIPE context, the SEC’s position is apparently based on the fact that allowing a PIPE investor to sell short an issuer’s stock and then later cover the short position with PIPE shares would enable PIPE investors “to invest in PIPE offerings without incurring market risk.”¹⁶⁵ There are at least two problems with this justification. First, Section 5 is about ensuring disclosure, not preventing investors from avoiding market risk. Second, the SEC allows PIPE investors to avoid market risk by short selling so long as the short position is covered by shares purchased in the open market. If the issue really is about market risk, shouldn’t the SEC interpret Section 5 to prohibit this as well?

It should be noted that Rule 105 of Regulation M under the Exchange Act does prohibit an investor from selling shares short within five business days of the pricing of a firm commitment public offering and then covering the short sales with shares purchased in the public offering.¹⁶⁶

¹⁶² Order, *Spinner*, *supra* note 128, at 2-3.

¹⁶³ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) citing H.R. Rep. No. 85, 73d Cong., 1st Sess., 1-5 (1933). See also Loss & Seligman, *supra* note 64, at § 1-H-6.

¹⁶⁴ See Loss & Seligman, *supra* note 59, at § 2-B-1a.

¹⁶⁵ *Id.* at 5.

¹⁶⁶ See 17 C.F.R. § 240.242.105 (2006). See also *In re Imperium Advisors, LLC*, at 2, available at <http://www.sec.gov/litigation/admin/2007/34-55483.pdf>.

This prohibition, however, is not based on Section 5 but on the antifraud and anti-manipulation provisions of the securities laws.¹⁶⁷ Regardless, the prohibition does not apply to PIPE related transactions because they do not involve firm commitment underwritings.

At any rate, by prohibiting a PIPE investor from covering a short position with PIPE shares, the SEC is not ensuring that PIPE investors are subject to market risk. What it is ensuring is that the investors will be subject to increased unwinding risk. Unwinding risk is the risk that it will be difficult or expensive to unwind or closeout a hedged position. Unwinding risk is minimal if a PIPE investor can use PIPE shares to close out its position. It simply delivers the PIPE shares to cover the short position once the resale registration statement for the PIPE shares is declared effective. Since the SEC does not allow this, the investor will instead need to have a broker execute a sale order for the PIPE shares and a buy order for market shares. Hence, the PIPE investor will have to pay a brokerage commission on each order and will also likely lose money on the bid/ask spread.

This assumes that the orders can be executed simultaneously. Simultaneous execution, however, will be difficult with respect to the shares of many PIPE issuers because their stocks are thinly traded.¹⁶⁸ Hence, PIPE investors also have to bear the risk of potential adverse price movement following execution of one order but before execution of the other, and the thinner the market for a PIPE issuer's shares, the greater the risk. The end result is that PIPE issuers will have to compensate investors for this unwinding risk through a greater market discount, increased warrant coverage, etc. Alternatively, PIPE investors may insist on a floating PIPE deal because the repricing mechanism would provide a built-in hedge thereby reducing unwinding risk (PIPE investors will be hedged against market risk without having to engage in short selling).

V. REGULATORY ARBITRAGE AND THE SEC'S RESPONSE

Hedge funds are able to reap positive abnormal risk adjusted returns from investing in PIPEs in part because they are engaging in regulatory arbitrage. This becomes apparent when a PIPE transaction is compared to an underwritten, firm-commitment, follow-on public offering of common stock (seasoned equity offering or "SEO" for short).

A. PIPE vs. Seasoned Equity Offering

¹⁶⁷ See 17 C.F.R. § 242.100(a) (2006).

¹⁶⁸ See Chaplinsky & Haushalter, *supra* note 4, at 18 ("By all accounts, the shares of PIPE issuers are far less liquid than the typical firm.").

In an SEO, an issuer sells shares of common stock at a market discount to a syndicate of underwriters. The syndicate then promptly resells the shares to the public. In a typical PIPE transaction, an issuer sells common stock or securities convertible into common stock at a market discount to a "syndicate" of hedge funds. The "syndicate" then promptly resells the PIPE shares to the public, either directly, if the closing is conditional on the effectiveness of the resale registration, or, if not, indirectly through short sales.

The regulatory implications for the underwriters of a follow-on public offering as compared to those for investors in a PIPE, however, are much different. For example, Regulation M under the Exchange Act places a whole host of trading restrictions on underwriters at specified times during the public offering.¹⁶⁹ Regulation M generally has no application to PIPE investors. Further, the National Association of Securities Dealers, Inc. (NASD), the self regulatory organization of which virtually every investment banking firm in the United States is a member and hence subject to its rules, regulates public offering underwriting compensation.¹⁷⁰

Specifically, NASD Rule 2710 provides "no member or person associated with a member shall receive an amount of underwriting compensation in connection with a public offering which is unfair or unreasonable."¹⁷¹ Under the rule, an underwriter is required to make certain filings with the NASD specifying the underwriter's proposed compensation.¹⁷² The NASD then adds up all "items of value" to be received by the underwriters in connection with the offering including discounts, commissions, expense reimbursements, and warrants¹⁷³ and then notifies the underwriters as to whether it finds the proposed compensation unfair or unreasonable. The NASD presumably uses a multi-factored formula to make the determination but refuses to provide the specific formula out of concern that doing so "would tend to encourage members to charge issuers the maximum compensation allowed"¹⁷⁴

The NASD has indicated that the gross dollar amount, type of underwriting (firm commitment/best efforts), and type of offering (initial/follow-on) are relevant to the calculation.¹⁷⁵ In a 1992 Notice to Members,

¹⁶⁹ See JOHNSON & McLAUGHLIN, *supra* note 81, at § 4.02.

¹⁷⁰ See NASD Conduct Rule 2710. See also JOHNSON & McLAUGHLIN, *supra* note 81, at 6-9.

¹⁷¹ NASD Conduct Rule 2710(c)(2)(A).

¹⁷² *Id.* Rule 2710(b).

¹⁷³ *Id.* Rule 2710(c)(3).

¹⁷⁴ Exchange Act Release No. 30,587 (Apr. 15, 1992), 1992 WL 81746, at *7.

¹⁷⁵ A 1992 NASD Notice to Members provides:

In determining the maximum amount of compensation that is considered fair and reasonable, the NASD considers the size of the offering and the amount of risk assumed by the underwriter, which is determined by whether the offering is being underwritten on a firm commitment or best efforts basis and whether the offering is an

the NASD indicated that “generally accepted levels of underwriting compensation” for a firm commitment follow-on offering as a percentage of gross dollar amount of the offering was 14.57% for a \$1 million deal, 10.72% for a \$5 million deal, and 8.18% for a \$10 million deal.¹⁷⁶ A PIPE deal does not fall within the ambit of Rule 2710. Thus, there are no restrictions on the “compensation” hedge funds can receive for doing the deal. As mentioned above, the “All-in” discount for PIPE deals ranges from 14.3% to 34.7%, well above the maximum the NASD would allow an underwriter to charge for a follow-on public offering.¹⁷⁷

Additionally, underwriters face potential liability under Section 11 of the Securities Act for material misstatements in, or omissions from, registration statements of offerings they underwrite, subject to the due diligence defense.¹⁷⁸ Hence, a standard part of an SEO is a due diligence investigation of the issuer by the lead underwriter and its counsel.¹⁷⁹ Not only is this investigation necessary to preserve the due diligence defense, but it is necessary to protect the underwriters reputational capital. By bringing an offering to the market, an underwriter implicitly certifies the legitimacy of the offering to the marketplace.¹⁸⁰ If it turns out that the certification was misplaced, the underwriter’s reputational capital will take a hit. Therefore, an underwriter will not proceed with a deal if the investigation uncovers major problems with the issuer. Conversely, a hedge fund generally does not face potential liability under Section 11

initial or secondary offering. The maximum guideline amount generally will vary directly with the amount of risk assumed by the underwriter and inversely with the dollar amount of offering proceeds. Firm commitment offerings are permitted higher levels of compensation than best efforts offerings due to the risk involved in an underwriter purchasing the securities for resale versus simply utilizing its best efforts to place the securities for the issuer. In addition, a firm commitment initial public offering (IPO) is generally permitted higher compensation than a firm commitment secondary offering because the underwriter is dealing with an unseasoned issuer and is likely to incur higher costs in introducing the issuer to prospective underwriters and investors. The higher percentage levels of compensation permitted in smaller offerings recognizes that certain fixed costs are involved in any distribution, regardless of size. NASD Notice to Members 92-53 (1992), available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000407.

¹⁷⁶ *Id.*

¹⁷⁷ See Chaplinsky & Haushalter, *supra* note 4, at 3.

¹⁷⁸ See 15 U.S.C. § 771 (2006).

¹⁷⁹ See generally William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 555 (2006).

¹⁸⁰ John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1220-21 (1997).

when investing in a PIPE deal nor is its investment in a deal viewed as an implicit certification of the issuer. Hence, it can get away with performing minimal due diligence.

The bottom line is that hedge funds are engaging in regulatory arbitrage when they invest in PIPE deals. They are in essence underwriting SEOs but avoiding many of the regulations applicable to traditional underwriters. Hence, they can sell short stock in PIPE issuers at anytime during the “distribution,” they can charge as much in “compensation” as the PIPE issuer is willing to pay, and they can choose to perform minimal due diligence. Further, they do not have to compete for deals against SEO underwriters. Virtually no investment banking firms underwrite SEOs for small companies. The economics simply do not make sense for them to do so in large part because the NASD cap on underwriting compensation is too low. Underwriters are not able to charge enough to make up for the small deal size, heightened liability, and reputational concerns associated with small company offerings. Therefore, they do not do them.

B. SEC Response

This regulatory arbitrage has not gone unnoticed by the SEC. In particular, the SEC has recently taken the position that some PIPE investors may, in fact, be underwriters. Specifically, the SEC now generally views a resale registration statement with respect to 33% or more of a PIPE issuer’s “public float”¹⁸¹ as a primary as opposed to a secondary offering.¹⁸² Thus,

¹⁸¹ “Public float” means shares held by non-affiliates of the issuer. See InvestorWords.com, Public Float Definition,

http://www.investorwords.com/3936/public_float.html (last visited August 26, 2007).

¹⁸² See Sargent, *supra* note 44, at 13; Judith Burns, *SEC Slows Flow of PIPE Deals to a Trickle*, WALL ST. J., Dec. 27, 2006, at C1. An SEC Telephone Interpretations Manual provision issued in 1997 provides the following with respect to the primary/secondary offering issue:

It is important to identify whether a purported secondary offering is really a primary offering, i.e., the selling shareholders are actually underwriters selling on behalf of an issuer. Underwriter status may involve additional disclosure, including an acknowledgment of the seller's prospectus delivery requirements. In an offering involving Rule 415 or Form S-3, if the offering is deemed to be on behalf of the issuer, the Rule and Form in some cases will be unavailable (e.g., because of the Form S-3 "public float" test for a primary offering, or because Rule 415 (a)(1)(i) is available for secondary offerings, but primary offerings must meet the requirements of one of the other subsections of Rule 415). The question of whether an offering styled a secondary one is really on behalf of the issuer is a difficult factual one, not merely a question of who receives the proceeds. Consideration should be given to how long the selling shareholders have held the shares, the circumstances under which they received them, their relationship to the issuer, the amount of shares involved,

investors listed in such a resale registration statement are considered underwriters and therefore subject to Section 11 liability.¹⁸³

It is not clear where the 33% number comes from. Historically, PIPE issuers routinely registered for resale on shelf registration statements a number of PIPE shares equal to many times their public floats.¹⁸⁴ This practice was implicitly endorsed by the SEC because it had reviewed and signed off on many of these registration statements. In April 2006, however, the SEC began refusing to declare effective secondary registration statements for PIPE shares in excess of 33% of an issuer's public float, casting a cloud over the PIPE market.¹⁸⁵ It communicated its position not through a formal interpretive release or rulemaking, but on an ad hoc basis through individual comment letters.¹⁸⁶

In late January of this year, the SEC did remove some uncertainty concerning the primary/secondary offering issue. Curiously, it did not do so through any official channel, but instead through a speech delivered by David Lynn, the SEC's Chief Counsel of the Division of Corporate Finance, at the annual PIPE conference held in New York City on January 26, 2007.¹⁸⁷ Hence, the exact policy justification for the reinterpretation

whether the sellers are in the business of underwriting securities, and finally, whether under all the circumstances it appears that the seller is acting as a conduit for the issuer. SEC TELEPHONE INTERPRETATIONS MANUAL, *supra* note 86 (Securities Act R. 415, Jul. 1997) at § 29.

¹⁸³ In such a situation, PIPE investors would fall under the definition of underwriter because they would be participating in a "distribution" of securities. See 15 U.S.C. § 77b(a)(11) (2006).

¹⁸⁴ See Burns, *supra* note 182.

¹⁸⁵ See Sargent, *supra* note 44, at 13; Burns, *supra* note 182.

¹⁸⁶ See Sey-Hyo Lee, Kevin C. Smith, Ruslan Koretski, *PIPEs Clogged*, MONDAQ BUS. BRIEFING, (Mar. 12, 2007) available at: <http://www.mondaq.com/article.asp?articleid=46040> (Last visited Aug. 25, 2007).

¹⁸⁷ Greenberg Traurig, LLP, *News Alert for Pipe Investors – SEC Clarifies Position on Shelf Registration Issues Relating to PIPEs*, PRIVATE FUNDS WEEKLY ROUNDUP, Jan. 29, 2007, <http://www.gtlaw.com/pub/alerts/2007/0129.pdf>. The law firm Greenberg Traurig summarized the guidance as follows:

- The SEC will apply a cap to the registration of common stock underlying convertible securities (such as notes, warrants and preferred stock) equal to 33% of the issuer's float. This cap includes convertible securities with variable conversion prices (such as re-set provisions). On a facts and circumstances basis, the SEC will consider permitting an issuer to register more shares than this cap where there are mitigating factors based upon the six factor test contained in the SEC's telephone interpretation [see *supra* note 182], such as: (i) a large number of investors unaffiliated with the issuer and each other; (ii) a conversion price that is fixed and above market; (iii) a minimal discount price for the securities issued in the PIPE; (iv) a lengthy holding period for the securities held by the investor; and, (v) selling shareholders consisting of retail investors

remains unclear. Some people speculate that the underlying policy is “protect[ing] the small investor from risk of dilution.”¹⁸⁸ However, the fact that hedge funds are taking advantage of regulatory loopholes to profit arguably at the expense of existing PIPE issuer shareholders surely plays a role.

C. The Impact on Small Companies

The end result of the SEC’s new position on primary versus secondary offerings is essentially a cap on the size of PIPE deals.¹⁸⁹ In terms of dollar amounts, the lower the dollar value of a company’s public float, the less money it will be able to raise through a PIPE. Hence, the cap hits small companies the hardest, the very companies that have few, if any, other financing options.

In theory, an issuer could avoid the cap by registering the PIPE shares for resale as a primary shelf offering under Rule 415.¹⁹⁰ In practice, however, this will rarely, if ever, be an option. A hedge fund likely will be unwilling to invest in a PIPE deal where the resale will be registered as a primary offering because, as noted above, the fund would then be subject to Section 11 liability.¹⁹¹ If a fund was nonetheless willing to invest, it would

rather than hedge funds and other professional investors who are in the business of underwriting securities.

- The SEC is expected to allow an issuer to exceed the 33% cap where the issuer is registering solely common stock rather than convertible securities. However, this will be permitted on a case-by-case basis applying the six factor test set forth above.
- Where an issuer breaks up the registration of securities sold in a PIPE transaction into several registration statements or breaks up the PIPE financing itself into several similar transactions to comply with the 33% cap, the SEC will not clear a follow-on registration statement until the LATER of (i) 6 months and (ii) 60 days following the date all or substantially all of the previously registered securities are sold. Accordingly, investors may be forced to sell out of their registered positions in order for the balance of their securities to be registered although Mr. Lynn acknowledged after questioning from the crowd that the SEC may “reconsider” this element. If the issuer commences another deal for another purpose (such as to finance an acquisition rather than for working capital) while the first registration statement is effective and shares remain eligible for re-sale, the SEC will not block the second registration statement. They will apply the integration test and look for overlapping investors, similar terms and similar use of proceeds. *Id.*

¹⁸⁸ See Sargent, *supra* note 47, at 13.

¹⁸⁹ See *id.*

¹⁹⁰ See 17 C.F.R. § 230.415(a)(1)(ix) (2006).

¹⁹¹ See Sargent, *supra* note 47, at 13 (noting that underwriter status would require hedge funds investing in PIPEs to perform a substantial amount of due diligence on the PIPE issuer, “an undertaking that most hedge funds are simply not will to do”).

obviously require compensation for the Section 11 liability risk and attendant increased due diligence expense thereby making the deal even more expensive for the PIPE issuer.

VI. CONCLUSION

PIPE financing has emerged as a major funding source for small public companies. The large bulk of this financing comes from hedge funds. Hedge funds invest in PIPE deals because it is profitable to do so. By legally skirting various regulations, hedge funds are able to earn market-beating returns. Hence, it is not surprising that the SEC has taken steps to tighten the regulatory net.

However, whether further regulation is necessary or warranted is an open question. While PIPE deals are susceptible to abuse, as documented in the various SEC enforcement actions mentioned above, minimizing fraud is just half of the equation. The SEC should also consider the effect increased regulation will have on the PIPE market, considering that it represents the sole financing option for many small public companies. Consequently, any further regulation should be done in a measured and transparent manner in the form of proposed rules subject to public comment and economic analysis. The PIPE market is now too important for new rule interpretations to be promulgated informally through comment letters and speeches.

